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International Economic & Energy Weekly



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18 January 1985

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DI IEEW 85-003
18 January 1985

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**International
Economic & Energy
Weekly**

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**International
Economic & Energy
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Synopsis

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1	Perspective—<i>Eastern Europe: Growing Diversity in Economic Policy</i> <input type="text"/>	
	Unlike in the past two decades, the East European countries in the 1980s are pursuing divergent economic strategies to cope with their varied economic situation. Moscow has tolerated this diversity in economic policy making as long as party control remains unchallenged. <input type="text"/>	25X1
11	Poland: Mixed Performance Prospects for 1985 <input type="text"/>	25X1
	Warsaw is still reluctant to take the steps needed to deal with the basic causes of its economic problems. <input type="text"/>	25X1
17	Hungary's 1985 Plan: The End to Austerity <input type="text"/>	25X1
	After six years of economic austerity designed to stabilize Budapest's foreign payments situation, the 1985 plan calls for increased domestic demand and no further cuts in real wages or investment. <input type="text"/>	25X1
23	Yugoslavia: Financial Recovery Remains Elusive <input type="text"/>	25X1
	Despite the optimistic forecast Yugoslavia has given its creditors, we believe debt servicing constraints will limit growth for the rest of the decade. <input type="text"/>	25X1
29	East Germany: A Case of Successful Adjustment <input type="text"/>	25X1
	Following several years of painful austerity and major foreign trade adjustments, East German economic growth rebounded in 1983-84 making East Germany the standout economic performer in Eastern Europe. <input type="text"/>	25X1
35	Romania: On a Financial Tightrope <input type="text"/>	25X1
	Ceausescu's strategy for continued reductions in Romania's foreign debt without help from the IMF or foreign creditors will be undermined by poor export prospects and worsening domestic strains from the required austerity. <input type="text"/>	25X1

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**International
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18 January 1985

Perspective***Eastern Europe: Growing Diversity in Economic Policy***

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Unlike in the past two decades, the East European countries in the 1980s are pursuing divergent economic strategies to cope with their varied economic situations. Differences in policy emerged as a result of the debt crisis triggered by Poland in 1981, which—combined with reduced Soviet subsidies—forced most of Eastern Europe into major adjustment programs. Economic relations with the West, differences in domestic political pressures, and contrasting leadership and management styles have shaped each country's policy response.

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Western assistance—debt relief and new credits—has been a key ingredient in easing the financial problems of these countries. Recently, however, some regimes either have chosen or have been forced to reduce economic reliance on the West while others seem ready to expand trade:

- **Romania** has made the sharpest reversal in its policy on economic relations with the West. Bucharest secured debt relief and IMF credits in 1982-83, but President Ceausescu has banned new borrowing, denounced the IMF, and is pursuing a policy of paying the debt off through hard currency trade surpluses wrung from an already severely strained economy.
- **Poland** anticipates that IMF membership and a new rescheduling agreement with Western governments will help it regain access to Western credits. Warsaw's mountain of debt and continuing political problems, however, make it a poor credit risk, and it probably will have to manage with reduced levels of Western goods.
- **Yugoslavia** has received substantial Western debt relief, new credits, and IMF assistance and is counting on even more generous rescheduling terms from Western banks and governments. Belgrade's reputation for poor economic management, however, is likely to frustrate its inflated expectations.
- **Czechoslovakia**, although unscathed by the region's financial crisis, will continue to limit Western imports and keep reducing its modest hard currency debt.

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- **East Germany and Hungary** have avoided embarrassing reschedulings. For East Germany, the large West German financial umbrella has been important; for Hungary, a timely decision to join the IMF has combined with a reputation for good management to reassure bankers. Recent large syndicated loans have demonstrated the improved credit rating of both countries. []

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Political forces have helped shape adjustment policies as well as approaches to economic reform. The Jaruzelski regime has been most sensitive to public reactions to austerity. Although it took advantage of martial law to boost prices sharply in 1982, it is now allowing for increases in real income.

Hungary, and to a lesser extent East Germany and Yugoslavia, have also fashioned adjustment policies that protect living standards. For these countries, however, the resulting burden on investment could hurt their ability to provide enough growth to satisfy future consumer aspirations. With Ceausescu apparently confident of his ability to maintain control, Romania has not hesitated to implement increasingly severe austerity measures. []

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Although resistance by entrenched bureaucracies is the main political obstacle to market-type reforms throughout the region, the strength of this opposition varies widely. Hungary's preference for decentralization and market-type forces appears to rest on recognition that further economic progress depends on continuing reliance on trade with the West, enhanced export competitiveness, and systemic changes to enhance efficiency. East Germany, on the other hand, has successfully improved productivity and resource allocation by refinements in its tightly controlled but well-managed system. Poland gives lip service to self-management and other reforms but remains unwilling to take major steps. Romania shows no interest in decentralization, and its Stalinist economic policies reflect Ceausescu's autocratic and repressive style of leadership. In contrast, Yugoslavia suffers from excessive decentralization that prevents the collective leadership from implementing the economic reforms needed to attack the root causes of financial problems. []

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Moscow seems willing to tolerate some diversity in economic policy making as long as party control remains unchallenged. The Soviets, []

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[] approved Hungary's reform efforts provided that Budapest meets its CEMA obligations. The USSR apparently recognizes that the economic strength of the Warsaw Pact is enhanced by relations with the West as well as limited experimentation with reforms. The Soviets play a strong cautionary role, however, particularly when Western contacts have political overtones that run counter to, or get ahead of, Soviet East-West policy. Moreover, Moscow's renewed efforts to foster more joint planning within CEMA could eventually narrow the bounds for market-oriented reforms and trade relations with the West. []

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Briefs**Energy***North Sea
Oil Prices*

[redacted] Statoil and BNOC—the Norwegian and British national oil companies—have agreed with oil buyers to set purchase prices in line with spot market levels. Norwegian oil prices for December probably will drop about \$1 per barrel from the last official price and approximate \$28; January prices could fall to \$27 per barrel. [redacted]

[redacted] A change in official North Sea prices has been expected since December, but Oslo and London have hesitated to announce a new oil price mechanism because OPEC threatened that a linkage to spot market prices could cause an oil price war. The new North Sea pricing poses a dilemma for OPEC members—especially Nigeria. Lagos has vowed to match North Sea prices [redacted]

*Eastern Europe
Energy Shortages*

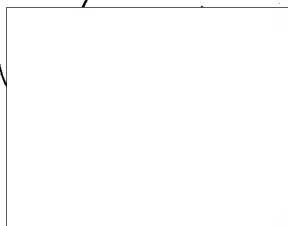
Harsh weather since the beginning of the year has led to widespread energy shortages and production problems in Eastern Europe. The worst problems are in Romania, where shortages have been reported since early November. Bucharest has ordered around-the-clock coal mining, cuts in household electricity use, strict limits on power consumption in factories, and a ban on the use of private cars. To cut peak power demand, work shifts are to be shorter but will be increased from six to seven days a week in most factories. Interruptions in coal deliveries in East Germany led a major power plant to shut down temporarily and caused several factories to close in the past two weeks. Coal deliveries have slowed in Czechoslovakia, and gas supplies to industrial users have been cut by more than 10 percent. In Yugoslavia, cold weather has sent electricity consumption soaring and disrupted coal, heating oil, and gas supplies. Officials are negotiating with large industrial users to lower consumption and have appealed to the populace to cut back. Sporadic electric power cuts and heating reductions have been reported in Bulgaria, and officials have implemented measures to conserve energy. East European countries have faced similar difficulties in the past, and most should be able to avoid major disruptions unless temperatures remain abnormally low. The difficulties in Romania, however, are likely to continue beyond the winter.


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Iranian Oil Workers' Strikes



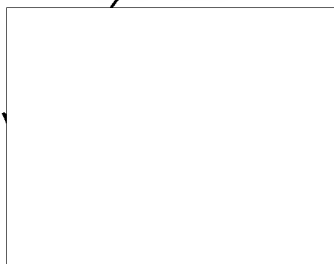
A high-level Iranian bank official told US officials in Abu Dhabi that strikes by oil refinery workers in Shiraz and Tabriz are contributing to serious shortages of home heating oil in Tehran and other northern Iranian cities. The affected refineries produce nearly 15 percent of Iran's refined petroleum products. Because Iran experiences shortages of heating oil every winter, the oil workers probably timed their strike to achieve maximum leverage. The government's problem is compounded by a lack of hard currency, which makes it difficult to import more refined oil to offset losses from the strike. 

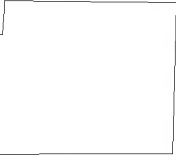
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International Finance



Peru's Debt Stalemate



President Belaunde is trying to break the stalemate with foreign lenders, but still refuses, for political reasons, to submit to an IMF program. 

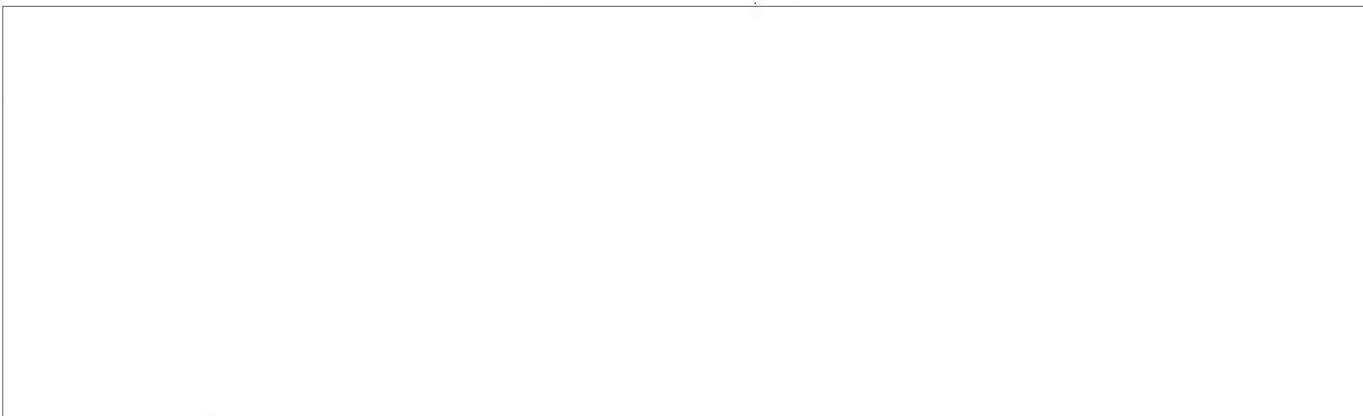
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 trade credits are drying up, according to a US Embassy source. We judge that Belaunde probably will opt for patchwork financial measures until he leaves office in July. The government has increased currency devaluations, approved gradual hikes in gasoline prices, and requested consultations with the Fund. Such moves probably will prevent a declaration of default but leave a legacy of tough financial problems for Belaunde's successor. 

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*Dominican Republic's
Troubled IMF
Negotiations*

Squabbling within the ruling party is delaying an agreement with the IMF and undermining President Jorge Blanco's efforts to right the economy. The Senate has unanimously rejected the administration's tax plan designed to obtain an IMF standby loan. The IMF has suggested further substantial boosts in petroleum and electricity rates as an alternative to tax increases. Meanwhile, the country's financial position continues to deteriorate. Official reserves in late 1984 were equivalent to only two to four weeks' worth of imports. Despite the recent rescheduling of petroleum-related debt to Venezuela and a US grant of \$50 million, unpaid debt still exceeds official reserves by as much as \$600 million. [REDACTED]

Jorge Blanco probably remains committed to reaching an accord with the IMF, despite the recent setback. Continued delays in implementing an IMF program not only would jeopardize the accord itself but also postpone renegotiation of external debts and the initiation of new foreign funding. Some international creditors, increasingly impatient because they have not even received interest payments from the Dominican Republic since November, are hinting at a cutoff of new funds. Without further debt relief, the country may not have enough cash in the coming weeks to cover essential debt payments—for oil, in particular—or enough imports of producer goods to keep the economy running. [REDACTED]

*Portuguese
Discussions
With the IMF*

The IMF has granted Lisbon a waiver on technical grounds for exceeding its 31 July short-term debt target. According to Embassy reporting, Portuguese officials will seek a waiver for a small overrun of agreed domestic credit limits for September, but not for a larger overshooting of the same ceiling in December. The Soares government would also like to have a Fund team return for Article IV consultations and for a review of the standby program in January if the IMF Board leans toward granting the waiver. Portugal plans to tap the commercial market for a \$350 million syndicated loan later this month or early in February, and the requests reflect Lisbon's desire to retain bankers' confidence. [REDACTED]

Global and Regional Developments

*Japanese-Soviet Trade
Talks To Resume*

Annual trade consultations between Japan and the USSR, which were suspended in 1982, are to resume in Tokyo on 22 and 23 January, according to the US Embassy in Tokyo. [REDACTED]

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*EC Increases Steel
Import Limits*

In annual negotiations with 15 third-country steel exporters, the Community has agreed to a small increase in steel imports by the EC countries. For most of these countries import tonnage in 1985 will be limited to 90 percent of the 1980 level—up from the previous limit of 87.5 percent. The higher limit for these voluntary export restraint accords partly reflects the Commission's belief that EC market conditions are improving. The Commission now has concluded bilateral arrangements covering 1985 steel imports from Bulgaria, Hungary, Czechoslovakia, Poland, South Africa, South Korea, Japan, Australia, Austria, Sweden, and Finland. Negotiations are continuing with Spain, Norway, Romania, and Brazil. Such arrangements cover approximately 80 percent of EC steel imports. Only European Free Trade Association (EFTA) countries—which have a free trade agreement with the EC—do not have to negotiate specific quotas, but must pledge to adjust their steel exports based on conditions in the EC's internal market.

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National Developments*Developed Countries**Mixed West German
Economic Performance*

A record trade surplus, low inflation, and relatively healthy 2.6 percent real GNP growth were the major pluses in West German economic performance last year. At 2.4 percent, inflation was near the bottom among OECD countries. Exports and GNP grew despite the disruptive metalworkers' strike last spring. Nominal export growth of 14 percent and 12-percent import growth yielded an \$18 billion trade surplus. About one-fourth of that came in the US market, as West Germany's US sales soared by an estimated 46 percent. The bad news was unemployment, which averaged 2.26 million, or 9.1 percent, although the seemingly inexorable growth of the last four years has leveled off.

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*Japan's Trade Surplus
Hits New Record*

Japan's trade surplus reached a record \$33.7 billion in 1984, up sharply from \$20.5 billion in 1983. Exports—led by office equipment, video tape recorders, semiconductors, and cars—totaled a record \$170.1 billion. Lower crude oil import prices helped hold imports at \$136.5 billion—up 8 percent over last year but still short of 1981's record level of \$143.3 billion. Japan's surplus with

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the United States hit a record \$33.1 billion as exports jumped 40 percent to \$59.4 billion, and purchases from the United States increased by only 9 percent. Sales to the United States accounted for 35.2 percent of Japan's total exports in 1984, compared with 29.1 percent in 1983. [redacted]

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South African Workers Threaten Strike

Black labor union officials are threatening a national strike of up to 1 million workers to protest actions of the government-owned synthetic fuel company (SASOL). SASOL fired 90 percent of its black workers—some 5,000—for joining a two-day general strike last November. The company has reinstated more than 1,500 of those dismissed and has promised to consider rehiring another 2,500, but union leaders demand 95-percent reinstatement. We believe that SASOL and union representatives are likely to reach a compromise before the end of the 30-day conciliation period required before a legal strike. [redacted]

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Less Developed Countries

Mexico Moves To Regulate Foreign Investment

Mexico probably will keep tight restrictions on foreign investment, despite rising government concern that foreign businessmen are refusing to put money in Mexico. [redacted]

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Even though the US Embassy suggests that some Mexican officials are pushing for a compromise, we believe that strong domestic opposition to foreign competition will reduce the President's willingness to be flexible. [redacted]

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Problems in Nicaragua's Coffee Harvest

Nicaraguan coffee exports are likely to be only half the official target of about \$160 million. [redacted] only 10 percent of beans were picked during the first half of the harvest season. The insurgents have disrupted operations at government plantations, and critical labor shortages are holding up harvests at other farms. The shortfall will aggravate financial difficulties because Managua has already spent revenue from the presold harvest and is likely to default on delivery commitments. [redacted]

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Major Cuban Aid Project in Nicaragua

Nicaragua last week dedicated the new Cuban-built Timal sugar refinery, Havana's largest single economic aid project in the Third World. [redacted] the plant is not scheduled to be fully operational until 1987. About 800 Cubans have worked on the project over the past two years. The [redacted]

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showcase project underscores Havana's commitment to Nicaragua as well as being a subject of Cuban pride. Timal incorporates the most financing—a loan equivalent to about \$50 million—ever provided by Havana for a foreign project. [redacted] Cuba may buy the mill's output to help meet its export contracts with the East Europeans, reducing the need for Cuba to purchase sugar on the world market. [redacted]

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Lebanese Government Economic Moves

The Lebanese Cabinet held a special session on the economy last Saturday, but failed to take effective action to correct the deteriorating situation. The Cabinet appointed a new Governor of the Central Bank, Edmond Main, an academic with no economic experience, and four vice governors, a Druze, a Shia, a Sunni, and a Catholic—politically correct but with no known financial experience. In addition, two committees were set up to seek solutions for Lebanon's economic problems. The only other action taken was to institute a special exchange rate for customs valuation on certain basic imports. The rate, which does not cover luxury items, automobiles, and products competing with local production, will slightly offset the inflationary impact of the falling pound. It will, however, also reduce customs duties, the major source of government revenue, thereby increasing the budget deficit. [redacted]

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Pakistan Implements Islamic Banking

The first stage of Pakistan's Islamic banking system is now in effect. As of 1 January, all financing by banks to the government, public-sector corporations, and joint-stock companies must be on Islamic—that is, noninterest—terms. This first stage probably will have little effect on the economy because we believe most transactions will involve government entities that will attempt to assure adequate rates of return without calling it "interest." Two other phases scheduled to be in effect by 1 July will require Islamic terms for all loans to private firms and individuals and will prohibit interest on bank deposits.

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[redacted] If Pakistani banks incur large loan losses or, if large-scale fraud becomes evident, Islamization of the economy will become a political issue. [redacted]

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New Pertamina President Shows His Clout

The new president of Indonesia's state oil company, Abdul Rachman Ramly, has quashed a refining and marketing deal that benefited a son of President Soeharto. According to well-placed Embassy sources, Bambang Soeharto's Singapore trading firm had been purchasing 100,000 b/d of Indonesian crude oil at the government selling price under an arrangement signed last September. The company reportedly marketed 20,000 b/d in third markets and refined the remainder. Half of the refined products reportedly were sold in Japan, where they undercut Pertamina's own pricing strategy, and half were resold to Pertamina at a premium sufficient to provide the trading firm a profit

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of \$1.35 to \$1.85 per barrel. When Ramly became aware of the financial implications, he enlisted the help of a senior government official to inform the President, who then terminated the arrangement. Ramly's success in ending the deal reflects his determination to improve Pertamina's financial management even at the risk of antagonizing Soeharto family members.

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Rebels Reduce Chad's Cotton Crop

This year's cotton crop—Chad's major export earner—is predicted to drop to 110,000 metric tons from last year's near-record 160,000 tons. This is within Chad's normal annual production range of 85,000 to 174,000 tons. Southern dissidents carried out a fairly successful campaign to disrupt planting by burning seed, uprooting plants, and driving peasants from their fields. The rebels now are sporadically attacking trucks transporting the cotton and impeding market activity to deny the cash-strapped government hard currency earnings.

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Communist

China Trying To Lure Taiwanese Investment

Xiamen, one of the four special economic zones opened to increase foreign investment, is trying to lure investment by firms based in Taiwan. According to a press report, Xiamen has offered special tax breaks and other advantages to businesses or joint ventures started by Taiwan interests and scheduled to operate for 10 years or longer. These enticements—more preferential than those offered other foreign firms—come at a time when Taiwan is similarly trying to lure businesses away from Hong Kong, which will come under Chinese jurisdiction in 1997. It is unlikely that the Taiwan Government would approve projects involving direct business ties with the mainland, although some Taiwan businessmen may invest through indirect channels.

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Vietnamese Food Production Stagnates

Adverse weather held foodgrain production in 1984 to 17 million metric tons—1 million tons below the government's target, according to preliminary official statistics. Moreover, production of subsidiary crops such as corn and potatoes declined sharply for the third straight year. The poor harvest, combined with population growth of 2.4 percent annually, puts an end to Hanoi's claim of self-sufficiency in food. Vietnam imported 150,000 to 200,000 tons of rice in 1984, and we expect substantial purchases again this year. Hanoi has already quietly requested food aid from the European Community and international organizations but will probably be turned down, according to diplomatic reporting.

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Poland: Mixed Performance Prospects for 1985

Warsaw is still reluctant to take the steps needed to deal with the basic causes of its longstanding economic problems. Political constraints will probably force the regime to once again bow to workers' demands for wage increases and higher priority for consumption. In other areas, little progress is being made in implementing reforms needed to streamline management, enhance efficiency, and introduce more effective tools of macroeconomic policy. In general, Warsaw's 1985 planned growth of GNP, industrial output, and agricultural production appears achievable, but the foreign payments targets are unrealistic. Almost \$18 billion, including nearly \$14 billion in arrears, comes due this year, but Warsaw has offered to pay only \$3.8 billion. In order to cover even the \$3.8 billion, the regime assumes new credits from Western governments and an initial drawing from the IMF. We project that, even under the unlikely case of ideal domestic conditions and 10-percent cuts in consumption, investment, and government spending, hard currency imports would not fall enough to meet Poland's payments goal.

Some Improvement but Problems Multiply

Polish economic growth remained positive in 1984 for the second successive year. Industrial production grew 4 percent although output in the coal and chemical sectors stagnated. We estimate that agricultural output rose by about 7 percent because of a near-record grain harvest. Nonetheless, GNP still is 2 percent below 1978 levels and industrial production lags 9 percent. Production quality has deteriorated, many basic foods continue to be rationed, and shortages of imported raw materials have held down output.

As in 1983, the government last year backed away from stringent austerity measures. Consumer goods received priority to curry popular support and to

Poland: Total Payments Due Creditors ^a

Million US \$

	1984	1985
Total	16,981	17,906
Paris Club	13,833	15,644
Of which:		
Arrears	10,800	13,776
Banks	1,185	1,495
Other	1,963	767

^a CIA estimate.

show progress in resolving the country's economic problems. When meat production fell last year, for example, the regime spent scarce hard currency for imported meat rather than lower ration levels. In the first three quarters of the year, the amount of consumer goods on the market increased about 8 percent. Warsaw kept the inflation rate below the planned level of 15 percent by raising food prices less than expected and limiting price increases of many consumer goods to 10 percent. As a result, budget subsidies rose more than 20 percent.

Meanwhile, the government made little effort to combat excessive wage hikes. Enterprises—receiving subsidies and tax concessions from the central government—gave in to workers' pressure to raise money wages by an average of 20 percent. As a result, real wages increased by more than 6 percent in the first three quarters of 1984 compared with the previous year—the highest increase since 1978.

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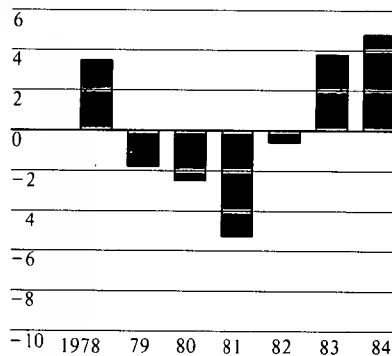
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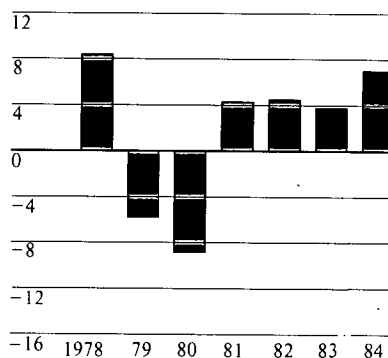
Poland: Economic Indicators

Note scale change

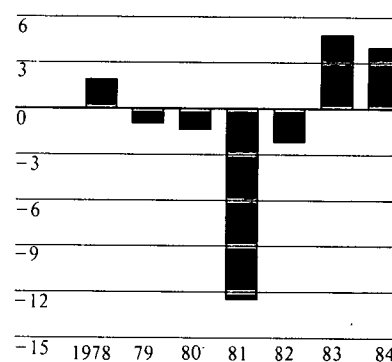
GNP Growth
Percent



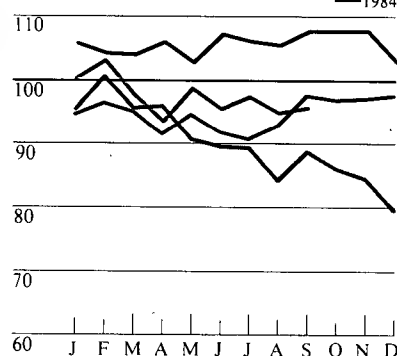
Agricultural Growth
Percent



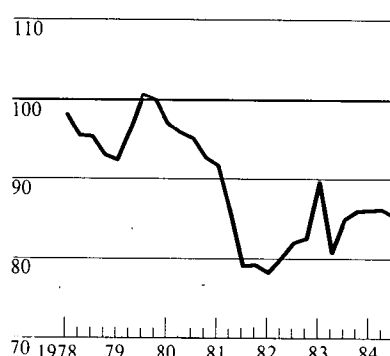
Industrial Production Growth
Percent



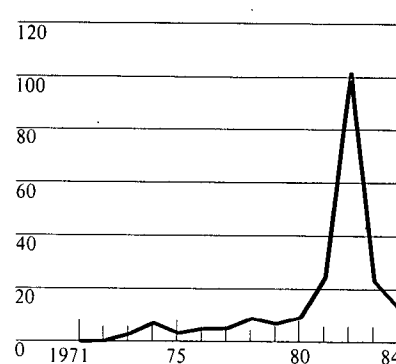
Industrial Production Index^a
Index: November 1976=100



Consumer Supply Index^a
Index: 1979 IV=100



Retail Price Changes
Percent

^a Seasonally adjusted.

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Warsaw also failed to keep the lid on investment spending and to shift it toward the export and consumer goods sectors. Investment rose 15 percent during the first three quarters of the year, instead of the planned 6-percent decline. Much of the spending went to large, heavy industrial projects revived in late 1983 after a two-year freeze. Most of these projects will require at least several years

of work before completion, are likely to be technologically obsolete, and probably will not increase production of exports or consumer goods.

The government gave little substance to its reform rhetoric. It continued to favor detailed central control. Over 40 percent of industrial inputs remain

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under some form of central administrative controls despite measures to decentralize decisionmaking. The authorities continued to subsidize inefficient firms, probably to avoid throwing workers out of jobs. Despite a well-publicized conservation program, some factories used more energy and raw materials without incurring any significant penalties. []

Trade and Financial Difficulties

Poland ran a hard currency trade surplus of \$1.2 billion in the first nine months of 1984, about \$150 million greater than the same period in 1983, largely because imports were held below planned levels. In real terms, hard currency imports rose 11 percent in constant zlotys (4.5 percent in US dollars), and hard currency exports increased 13 percent in constant zlotys (4.3 percent in US dollars). Exports of energy, agricultural, and mineral products rose while exports of machinery and construction services fell. Despite the increase, export performance was hurt by weak demand for poor-quality Polish goods. In addition, efforts to encourage exports—including the 20-percent devaluation of the zloty against the US dollar—were offset by domestic inflation and producers' continued preference for selling in the domestic market. []

Warsaw's financial strategy continued to focus on trying to secure generous debt relief. The moratorium on payments to Western government creditors allowed the Poles to minimize hard currency debt payments and to boost imports. Although the financing requirement for 1984 totaled about \$17 billion—over 80 percent consisting of arrears and payments due government creditors—Warsaw repaid only about \$1.9 billion, mainly to Western banks. The Polish Government rescheduled on favorable terms most of its 1984-87 payments to private banks—worth \$2.1 billion—and has reached agreement with the Paris Club on rescheduling principal and interest due in 1982-84. []

Poland ran about a \$325 million deficit with CEMA countries in the first nine months of 1984 mainly because of ahead-of-schedule deliveries of Soviet oil and the slowdown of Polish exports to

Poland: Hard Currency Foreign Payments

Million US \$

	1984 ^a	1985 Plan
Total payments capacity ^b	1,860	3,750
Earned	1,300	1,900
Hard currency trade	1,370	1,500
Exports	5,900	6,300
Imports	4,530	4,800
Invisibles, net ^c	400	500
Other, net	-470	-100
Borrowed	560	1,850
Guaranteed credits	340	850
Bank credits	220	400
IMF loans	NA	600

^a Estimated.

^b Payments capacity is the amount of debt service a creditor can pay by earning a surplus from trade and other current account transactions, excluding interest, and obtaining new loans from creditors.

^c Excluding interest.

CEMA countries in the third quarter. Poland's soft currency debt rose 10 percent in the first six months of 1984 compared with the same period of 1983 and amounted to the equivalent of \$6 billion by mid-1984. Polish officials have said that the Soviet part of the debt is covered by long-term low interest credits. The hard currency debt owed to the USSR reportedly was rescheduled until after 1986. []

Plans Versus Reality

The 1985 economic plan indicates that Warsaw will continue a muddle-through approach to its economic problems. Growth targets are moderate and in line with recent performance. Plans to reduce imbalances in the consumer goods market will require Warsaw to overcome its reluctance to enforce controls on wages and investment. Subsidy

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**Poland: Major
 Economic Indicators**

*Percent change
 from previous period*

	1983 ^a	1984 First Three Quarters	1985 ^a Plan
National income (produced) ^b	6.0	NA	3.0-3.5
Industrial production ^c	5.8	3.8 ^d	4.0-4.5
Agricultural production ^b	5.1	NA	-0.8-1.4
Investment ^b	9.4	15.0 ^a	0
Money wages	24.5	20.2 ^a	12.0-13.0
Retail prices	23.1	13.0 ^a	12.0-13.0
Real wages	1.1	6.4 ^a	0
Retail sales ^b	8.1	8.0 ^c	4.0-4.4
Hard currency trade ^b			
Export	12.4	12.9 ^a	7.2
Import	6.6	11.0 ^a	10.0
Soft currency trade ^b			
Export	8.3	4.5 ^a	7.1
Import	4.4	6.2 ^a	8.5

^a Official data.

^b Constant zloty prices.

^c First eight months of 1984.

^d Estimate.

cuts appear unlikely because of the political risks. The financial strategy remains unchanged, and Warsaw is still overoptimistic about its borrowing ability and foreign trade performance. There is no evidence of concrete action on long-overdue reforms to promote efficiency, foster more rational investment decisions, and provide greater incentives for exports.

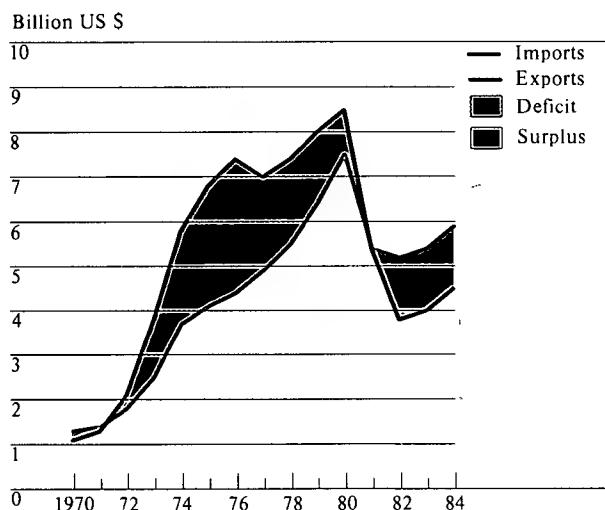
Domestic Targets. The 1985 plan calls for continuing moderate increases in industrial production and holding agricultural output close to last year's better-than-average level. Planned industrial growth is to come from more efficient use of raw materials and increases in productivity. These have been unreliable sources of growth in the past, however, and are not likely to be significant factors this year because of limited investment in more efficient capital stock in recent years and only

marginal improvements in worker incentives. Overall consumer supplies will rise about 4 percent, with food supplies up about 2 percent and the amount of meat rising only 1.1 percent. The higher planned growth rate in the consumption of nonfood items indicates that the regime has not yet discovered how to encourage food production without increasing hard currency imports. Although more funds have been channeled into agriculture, continuing shortages of many inputs (especially those dependent on hard currency imports) and a neglected infrastructure will limit increases in output, especially in the absence of good weather.

The government claims it will curb inflation in 1985—by cutting budget subsidies, freezing real wages, and reducing investment—but shows no inclination for a determined fight. The regime cannot lower subsidies and hold prices within the proposed 12 to 13 percent limit. Moreover, the government has taken no action to force firms to keep wage and investment spending in line with the plan. Firms are likely to continue to cave in to worker pressure for wage increases ignoring government recommendations that increases be linked to productivity gains. They have the funds because of generous government tax concessions and subsidies and suffer no penalties for ignoring guidelines. The money supply also will increase if many redeem the bonds that were issued to protect the value of savings when prices rose 100 percent in 1982. Plans to tighten investment credits in 1985 will not ensure reduced spending because of commitments to ongoing investment projects, which will cost more than \$12 billion over the next several years. High investment levels will increase pressures to import because investment historically has required large amounts of imports from both the West and CEMA.

External Finances. Warsaw plans to continue its practice of covering only a small portion of its financial obligations. Almost \$18 billion, including nearly \$14 billion in arrears to the Paris Club, is due this year, but Warsaw plans to repay only \$3.8 billion. Poland apparently plans not to make significant payments to Paris Club members and is

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Poland: Hard Currency Trade, 1970-84

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counting on rescheduling its Paris Club debt or continuing the de facto moratorium. []

The Poles, however, will have trouble coming up with even \$3.8 billion that assumes a trade surplus of \$1.5 billion. Such a surplus is possible only under ideal conditions, including a favorable grain harvest, implementation of planned investment cuts without producing capital stock shortages, and no further deterioration in the terms of trade. Moreover, because we expect Poland's net earnings from services and new credits to be closer to \$700 million than the projected \$2.3 billion, Warsaw would have to run a hard currency trade surplus of about \$3.1 billion to meet its payments goals. []

Our calculations indicate that, even with stringent austerity measures, the Polish economy could not generate a trade surplus of \$3.1 billion. We estimate that Warsaw's projection of a \$1.5 billion surplus is achievable but believe that \$1.3 billion is more likely under current conditions. Even under assumptions of drastic austerity—10-percent cuts

from 1985 planned levels of consumption, investment, and government spending—and the best of domestic circumstances, net hard currency earnings would reach only \$2.4 billion. Furthermore, savings on the hard currency import bill would diminish as the domestic belt is progressively tightened. For example, the first 2-percent cut in domestic demand would save \$325 million in hard currency imports, but the fifth cut (from an 8-percent cut to a 10-percent cut) saves only \$65 million in hard currency imports.¹ The Poles likely realize this and are unwilling to run the political risks of dramatic cuts in domestic trade absorption to realize progressively-shrinking gains in the foreign accounts.

An Optimistic Note

The withdrawal of US opposition to membership in the International Monetary Fund has given Poland hope that it will receive credits from the IMF and World Bank. If membership is granted in 1985, Poland would be eligible for \$450 million in IMF credits under limited conditionality. Further money would not come quickly or easily, however, because Warsaw would resist, for domestic political reasons, stringent but needed austerity measures that would likely be proposed by the IMF. Entry into the IMF, however, could give Poland a slightly better standing in financial markets. []

Outlook

Although the population accepted a large degree of austerity in 1982 under martial law, it probably is expecting greater improvements in living standards after several years of small increases. The regime, as in the past, most likely will back down and allow

¹ These calculations are based on POLGNP, our detailed economic model of Polish domestic economy-foreign trade interactions. The savings of hard currency imports decline with each reduction in domestic activity because a major function of imports is to break supply bottlenecks. At lower levels of economic activity, there are fewer supply bottlenecks, fewer imports are needed, so fewer imports are saved with each cut. []

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a rise in real wages to satisfy workers. The government probably will tolerate much more investment than is suggested by the plan. This could make inevitable future adjustments harsher and more politically difficult. In any case, sustainable economic growth will eventually require major changes in the economic system. Given the political problems facing the Jaruzelski regime, however, a gradualist approach may be the only feasible alternative. [REDACTED]

The Jaruzelski regime also realizes that sustained economic progress requires better ties with the West to allow Poland access to the new credits and IMF membership and to avoid economic stagnation over the longer term. On balance, Jaruzelski seems prepared to make some overtures to the West in the interest of improving economic ties, but he will be unwilling to pay too steep of a political price and will be anxious to avoid the appearance of linkage between any political concessions and economic benefits. [REDACTED]

[REDACTED]

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Hungary's 1985 Plan: The End to Austerity

The 1985 plan signals a fundamental change in Hungarian economic policy. After six years of economic austerity designed to stabilize Budapest's foreign payments situation, the 1985 plan calls for increased domestic demand and no further cuts in real wages or investment. The plan indicates that the leadership will rely on economic reform to increase labor and capital productivity, reduce raw material and energy consumption, and spur hard currency export growth. Budapest is also counting on continued strong support from Western bankers to help it meet 1985 debt service obligations.

Early 1980s in Brief

Hungary began the decade in serious financial trouble. Domestic adjustment measures, coupled with credit policies to boost hard currency exports and import restrictions, contributed to a gradual improvement in all major external accounts by the end of 1983. The hard currency trade balance moved gradually from a record deficit of \$800 million in 1978 to a surplus of \$900 million in 1983. At the same time, the hard currency current account improved from a \$1.2 billion deficit to a surplus of \$300 million reflecting not only the decrease in imports but also some growth in invisible earnings and a decline in net interest payments.

In recent years, Budapest has also relied very heavily on loans from Western bankers and financial institutions. A sharp cut in the availability of short-term credits in early 1982 pushed Hungary to the brink of financial crisis. A rescue package organized by the Bank for International Settlements (BIS) restored banker confidence, helping Hungary raise an estimated \$1.1 billion in medium- and long-term credits in 1982 and \$1.3 billion in 1983, in addition to loans from the IMF.

After drawdowns of foreign exchange reserves of \$1.3 billion in 1981-82, Budapest rebuilt reserves in 1983 to a level of \$1.9 billion, equivalent to almost six months of hard currency imports. Gross debt at the end of 1983 stood at \$8.3 billion, compared with a high of \$9.1 billion at the end of 1980.

Preliminary Look at 1984

Initial reports show that 1984 economic growth was a little stronger than planned, 2.0 to 2.5 percent, because of higher-than-expected industrial and agricultural output. According to official measures, industrial production rose 2.5 to 3.0 percent, due particularly to healthy boosts in the chemical, light, and food industries. At the same time, the agricultural sector outstripped growth targets with a grain harvest of over 15 million tons—slightly exceeding the bumper crop of 1982, according to official estimates.

Budapest used a combination of tight credit, restraints on government spending, and wage and price regulations to keep domestic demand within acceptable limits. Real gross fixed investment fell for the fifth consecutive year since 1979, although at a slower rate than originally planned. Average per capita consumption likewise registered only a slightly higher gain than planned, although the income gap between those with private-sector earnings and those solely dependent on a state wage widened further and contributed to social tension.

As of December 1984, high-level Hungarian banking officials were still predicting a hard currency current account surplus of \$300-400 million for the year, despite a disappointing trade performance in

Hungary: Domestic Economic Indicators

Percent

	1977	1978	1979	1980	1981	1982	1983	1984		1985 Plan
								Plan	Preliminary	
National income (net material product)	8.0	4.2	1.2	-0.9	2.5	2.6	0.4	1.5-2.0	2.0-2.5	2.3-2.8
Domestic utilization	6.2	10.0	-5.8	-1.7	0.7	-1.1	-2.7	-1.0-2.0	NA	1.0-1.5
Real gross fixed investment	13.0	4.9	1.0	-5.8	-5.1	-2.2	-3.3	-7.0-8.0	NA ^a	0
Real per capita consumption	4.1	3.3	1.9	0.6	2.6	1.3	0.5	0-0.5	1.0	1.0-1.5
Industrial production	6.6	4.9	3.0	-2.1	2.8	2.4	0.7	1.5-2.4	2.5-3.0	3.0
Construction industry production	6.4	3.7	0.8	-3.0	-0.2	0.5	-2.7	-2.0-3.0	NA	1.0-2.0
Agricultural production	10.3	2.0	-1.1	4.3	2.0	7.3	-3.2	0-1.0 ^b	5.0	1.0
Real per capita income	4.9	2.9	-0.2	0.7	2.9	0.9	0.9	0	1.0	1.5-2.0
Real average wages	3.8	3.1	-1.7	-1.6	1.1	-0.7	-3.1	-2.5	-2.5	0
Consumer price index	3.9	4.6	8.9	9.2	4.6	6.8	7.4	-7.0-8.0	8.5	7.0

^a Published results on investment for 1984 have thus far been vague; they indicate that the volume fell somewhat but exceeded the planned amount.

^b Compared with the bumper crop of 1982.

the first three quarters of the year. [] Hungary's exports once again suffered worsening terms of trade with a drop of 25 to 30 percent in the price of meat exports to the West and a fall of 6 percent in machinery prices. In recent years, however, Budapest has achieved as much as 50 percent of the year's trade surplus in the last quarter and probably did so again. The current account also benefited from a healthy dose of tourism receipts and perhaps from slightly lower interest rates on external debt. []

Western lenders responded enthusiastically to Budapest's requests in 1984, extending about \$1.6 billion, excluding short-term borrowing. Major loans included:

- A \$450 million IMF standby facility and World Bank project loans totaling \$200 million.
- A \$210 million consortium loan from US, Japanese, Arab, and West European banks signed in April.
- A World Bank cofinancing package providing \$487 million to support industrial export development and energy modernization.

- A \$300 million loan signed in December with a group of European, Japanese, and US banks. At the end of September 1984, Budapest's foreign exchange reserves stood at a very comfortable \$2.1 billion, compared with \$1 billion at the end of the third quarter of 1983. []

Plan for 1985

This year's plan indicates a new focus for Hungarian economic policy. In recent public addresses, economic policy makers—including Politburo member Ferenc Havasi and Planning Minister Lajos Faluvegi—have indicated that Hungary has successfully dealt with its external financial problems and that the austerity of the past several years has exhausted all the country's material and "emotional" reserves. These statements are supported by the 1985 plan targets, which allow for the first small increase in domestic demand since 1981 and call for a modest increase in economic growth. The

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Hungary: Selected Hard Currency Financial Indicators

Million US \$

	1978	1979	1980	1981	1982	1983	1984 ^a
Gross debt	7,290	8,140	9,090	8,699	7,715	8,257	7,722
Reserves ^b	2,136	2,230	2,558	2,033	1,300	1,910	2,100
Net debt ^d	5,154	5,910	6,532	6,666	6,415	6,347	5,622
Trade balance ^c	-782	-167	276	445	766	878	1,078
Current account balance	-1,242	-826	-370	-727	-92	298	400
Terms of trade (percent change)	0.9	-1.2	1.4	2.2	-1.1	-2.4	-4.0

^a Projected.^b Includes gold holdings valued by Hungary at \$126 per ounce in 1978 and \$226 per ounce thereafter.^c At the end of September.^d Gross debt minus reserves.^e Trade data are on a payments basis.

regime is concerned that five years of consecutive cuts in investment have damaged the future technological development of certain industries and postponed improvements in infrastructure. Budapest has targeted investment to remain at last year's level, or grow slightly if resources permit. At the same time, the leadership is anxious to rekindle popular support, which depends so critically on improvements in the standard of living, by allowing further growth of 1 to 1.5 percent in real per capita consumption.

Financing Strategy

Budapest's policy may lead to an important change in its external financing strategy this year as well. Following two years of relative success with IMF-supported programs, the Hungarians may not sign a new standby credit facility with the Fund for 1985. The US Embassy reported that negotiations with the Fund for a \$200-300 million loan broke off in late 1984. Hungarian bankers contend that, after viewing Budapest's improved financial picture, the IMF staff felt they would have difficulty convincing the Fund's management of the need for another standby. The IMF had indicated it might arrange a small standby loan provided Budapest was willing to implement structural reforms and adjustment measures beyond those it was already contemplating. The standby could only be drawn on in event of

extreme need. We believe that Budapest found the IMF's terms unattractive given the limited prospects for new credits. The Hungarians, nevertheless, anxious to maintain favorable relations, have apparently agreed to continue to provide the IMF with all the performance data that would normally be provided under a standby. An IMF mission will return to Budapest later in the year for further discussions on a standby program.

We estimate that Budapest needs to borrow a total of \$1.5-2.0 billion from Western credit markets to meet scheduled debt service payments of roughly \$2.3 billion this year. Barring uncontrolled growth in hard currency imports, a crop failure, or a sudden reversal in their ability to borrow, the Hungarians should be able to manage these obligations. The reaction of the Western banking community to the possible lack of an IMF facility will be a crucial factor in Hungary's borrowing success during the year. Remarks in the Western press by National Bank official Janos Fekete stress that the absence of an IMF program attests to the financial health of the Hungarian economy and should therefore strengthen the country's credit rating. More skeptical bankers, however, may feel less secure in extending new loans and, at the very least, will subject Budapest's accounts to more rigorous scrutiny and questioning.

**Hungary: Financing Requirements
and Sources, 1980-84 ^a**

Million US \$

	1980	1981	1982	1983	1984 ^b
Financing requirements	4,477	5,004	4,236	3,047	3,358
Current account balance	-370	-727	-92	298	400
Trade balance	276	445	766	878	1,078
Exports	4,863	4,877	4,876	4,848	4,994
Imports	4,587	4,432	4,110	3,970	3,916
Net interest	-409	-1,100	-976	-662	-671
Other net invisibles	-237	-72	118	82	-7
Repayment of medium- and long-term debt	811	826	894	1,216	1,535
Repayment of short-term debt	3,172	3,347	2,848	1,764	2,123
BIS payments	124	104	192	65	100
Net credits to other countries	0	0	210	300	0
Financing sources	4,624	4,816	4,310	3,141	3,402
Credits	4,952	4,291	3,577	3,751	3,602
Medium and long term	1,605	1,443	1,068	1,276	1,552
Short term	3,347	2,848	1,764	2,123	1,600
IMF, net	0	0	235	352	450
BIS	0	0	510	0	0
Change in reserves ^c	328	-525	-733	610	200
Errors and omissions	-147	188	-74	-94	-44

^a Trade data are on a payments basis.

^b Projected.

^c Includes changes in gold holdings.

Reforms

Wary that further cuts in investment will harm future economic development and fearful of the political reaction to prolonged efforts to hold down living standards, the regime has placed its bet for economic growth and stability on economic reform. During 1985, Budapest will begin implementing many of the measures passed at the April 1984 party plenum. The new reforms appear to be economically sound and promise to move the economy in a market-oriented direction. They affect all aspects of economic management, including wage and price deregulation, income tax reform, worker participation in factory management, private enterprise experiments, bank decentralization, and reorganization or dissolution of unprofitable firms.

If the reforms are to have the desired impact, particularly in the short or medium term, Budapest will have to enforce them strictly. It will have to withstand grumbling from industrial workers, trade union officials, insecure enterprise managers, and other groups, who will suffer from the reforms. Moreover, it will have to defend its more radical steps to Moscow and its other less reform-minded East European neighbors.

Hungary Remains Vulnerable

Regardless of Budapest's skill in managing its problems and improving its economic system, the

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Hungarian economy will remain extremely vulnerable to external shocks and will continue to depend on support from both East and West. Its ability to expand hard currency exports, for example, will rest to a large extent on the strength of Western recovery, trends in world prices for its export goods, and Budapest's ability to compete on world markets with many of the LDCs and other East European countries. Like all debtor countries, Hungary is also sensitive to changes in the international lending climate, interest rates, and world energy prices. Moreover, the Hungarians remain at the mercy of Soviet generosity and will be facing Moscow's demands for more and better quality exports in exchange for vital raw materials and energy supplies.

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Yugoslavia: Financial Recovery Remains Elusive

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Despite the optimistic forecast Yugoslavia has given its creditors, we believe debt servicing constraints will limit growth for the rest of the decade. Buoyed by improved export performance and current account surpluses in 1983-84, Belgrade believes that it can revive economic growth while reducing its debt through 1990. Yugoslav officials contend that the financial gains already made warrant lessened IMF supervision of the economy and a generous multiyear debt rescheduling from Western banks and governments. We believe Belgrade's expectations are unrealistic because the regime has done little to correct systemic problems that produced accelerating inflation and deteriorating trade performance in the past. Even with generous reschedulings, Yugoslavia could well face a shortfall in its external financing requirements beginning next year.

Performance in 1983-84

Yugoslavia has made progress in the past two years in recovering from its external financial crisis. At the beginning of 1983, Belgrade had all but exhausted its hard currency reserves, was some \$500 million in arrears to foreign creditors, and was losing access to private financing. A package of new credits and debt refinancing from Western governments and banks in 1983 and IMF standby loans helped stem the deterioration in Belgrade's financial position and cleared up arrears by the end of the year. Additional private and official debt rescheduling also helped in 1984. Moreover, Yugoslavia's trade and current account performance was much better than expected. Hard currency exports grew by 13 percent in 1983 and 10 percent in 1984, and an 11-percent cut in imports in 1983 was followed by a 2-percent upturn last year. As a result, the trade deficit fell from \$3.5 billion in 1982 to an estimated \$1.3 billion last year. Over

this period, Yugoslavia's current account balance moved from a \$1.6 billion deficit to an estimated \$730 million surplus.

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The improvement in the external accounts came at the expense of the domestic economy, but Belgrade can point to a few encouraging signs. Despite IMF-supported austerity measures that cut investment by 20 percent over the past two years, gross social product grew 2 percent last year following a 1.3-percent decline in 1983. Strong export gains helped boost industrial production 5 percent in 1984 following two years of near stagnation. The adjustment of private consumption has been much less severe. Withdrawals from dinar and private foreign exchange accounts and widespread moonlighting have shored up consumption levels in the face of falling real incomes. The major disappointment is that inflation has continued to accelerate despite efforts to curb domestic demand.

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Ambitious Plan for Debt Reduction

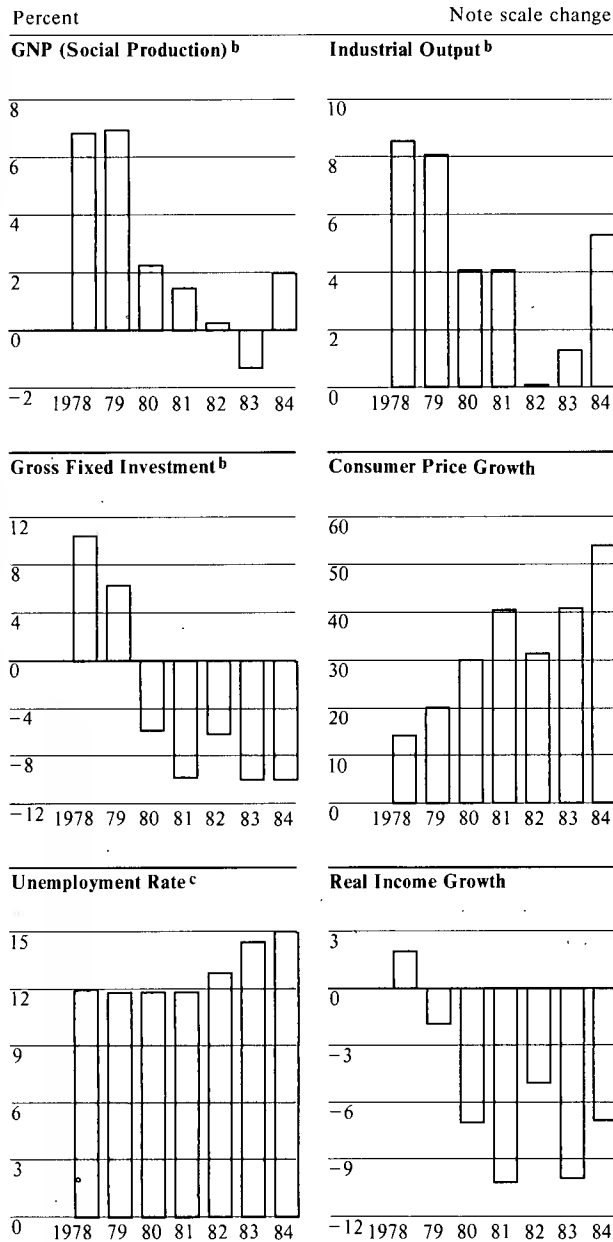
Encouraged by improved current account results, Belgrade contends that Yugoslavia can now afford a more expansionary economic policy. The Yugoslavs argue that the IMF-supported austerity program is provoking growing unrest and that some increase in investment and consumption is needed to sustain the country's recovery. A senior National Bank official has stated that Belgrade cannot continue to rely on decreases in domestic demand to improve its foreign payments position but must achieve further gains in exports through a significant increase in industrial production.

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Yugoslavia: Economic Indicators, 1978-84^a^a Third-quarter data for 1984.^b Constant prices.^c Official Yugoslav estimate.

To support its looser constraints on economic policy, Yugoslavia asked its private and official creditors in late 1984 for a generous multiyear rescheduling agreement and a reduction in IMF supervision. Belgrade argued that its improved financial performance entitled it to an arrangement similar to that received by Mexico. The Yugoslavs requested a rescheduling of loans maturing in 1985-88 extending repayments for a period of 10 to 12 years with a five- to six-year grace period and at lower interest rates than those of the 1983-84 reschedulings. Belgrade alleged that such an arrangement would facilitate economic management by reducing the uncertainties associated with annual debt rescheduling negotiations. The Yugoslavs stated that they wanted to replace their IMF standby agreement with a more relaxed monitoring arrangement similar to that given Mexico.

In conjunction with their request, the Yugoslavs presented their official and private creditors with a cash flow projection for 1985-90. The forecast envisions a \$3 billion reduction in hard currency debt and a \$2 billion increase in foreign exchange reserves over the period. Belgrade believes it can meet these targets with real export growth averaging 7 percent annually and current account surpluses of \$1.2 billion over the next several years. The Yugoslavs claim the projections are consistent with a 4-percent annual growth in the economy if domestic demand increases by only 3.6 percent to allow growth in net exports.

Both Western banks and governments have reacted coolly to the Yugoslav request. The official creditors rejected any multiyear arrangement because they did not want to establish a precedent for other Paris Club reschedulings and because they doubt Yugoslavia's financial performance has improved sufficiently to preclude new problems in the next few years. Western banks indicated that, instead of a single multiyear arrangement, they would refinance debts automatically at the beginning of each year in 1985-88 provided that the Yugoslavs met certain criteria. Both the governments and banks insisted on another IMF standby agreement for

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**Yugoslavia: Official Hard Currency
External Debt and Payments Projections, 1983-90**

Million US \$

	1983	1984 ^a	1985	1986	1987	1988	1989	1990
Financing gap	0	0	0	0	0	0	0	0
Financing requirement	4,038	3,600	2,950	2,900	2,800	3,300	2,600	2,600
Current account balance	299	730	1,250	1,400	1,350	1,090	1,000	1,070
Trade balance	-1,798	-1,340	-1,364	-1,379	-1,382	-1,372	-1,345	-1,298
Exports	6,271	6,898	7,657	8,499	9,434	10,472	11,624	12,903
Imports	8,069	8,238	9,021	9,878	10,816	11,844	12,969	14,201
Net services and transfers	2,097	2,070	2,614	2,779	2,732	2,462	2,345	2,368
Interest payments (net)	1,489	1,650	1,750	1,650	1,500	1,500	1,450	1,260
Repayment of medium- and long-term loan	2,560	3,200	3,450	3,500	3,400	3,500	3,000	3,000
Repayment of short-term loans (net)	670	100	200	200	100	100	0	0
Credits to foreign countries	157	100	250	300	350	430	480	540
Credits (other)	0	330	0	0	0	-110	-110	-110
Change in reserves	55	600	300	300	300	470	230	240
Errors and omissions	-1,005	0	0	0	0	0	0	0
Borrowing sources	4,038	3,600	2,950	2,900	2,800	3,300	2,600	2,600
Medium- and long-term credit utilization	4,038	3,600	2,950	2,900	2,800	3,300	2,600	2,600
Total rescheduling	1,766	2,190	1,605	1,512	1,312	920	0	0
New credits	2,272	1,410	1,345	1,388	1,488	2,380	2,600	2,600
Total debt outstanding	19,000	19,300	18,600	17,800	17,100	16,800	16,400	16,000

^a Estimated.

1985 and left open the possibility of a less strict monitoring arrangement thereafter. Belgrade eventually yielded on the issue of a 1985 standby agreement and has negotiated the general outline of a new one-year program with the Fund. The Yugoslavs, however, remain committed to winning a multiyear rescheduling in upcoming negotiations with Western banks and governments.

Reasons for Skepticism

Belgrade's forecast seems implausible because the regime has done little to correct the problems that prevented Yugoslavia from achieving growth with external balance in the past. The continuing increase in inflation shows that the Yugoslav econo-

my remains in serious imbalance. Although IMF-supported price increases, and devaluation of the dinar have contributed to inflation, the chief sources of inflation and dependence on Western imports are rooted in the Yugoslav system:

- Yugoslavia still lacks a capital market to ensure the efficient allocation of investment and foreign exchange resources.
- The workers' self-management councils often vote wage increases in excess of productivity gains.

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- Local authorities, under Yugoslavia's highly decentralized political and economic system, follow policies of autarkic development that have led to irrational and redundant investment, subsidization of inefficient enterprises, and protection of local monopolies. []

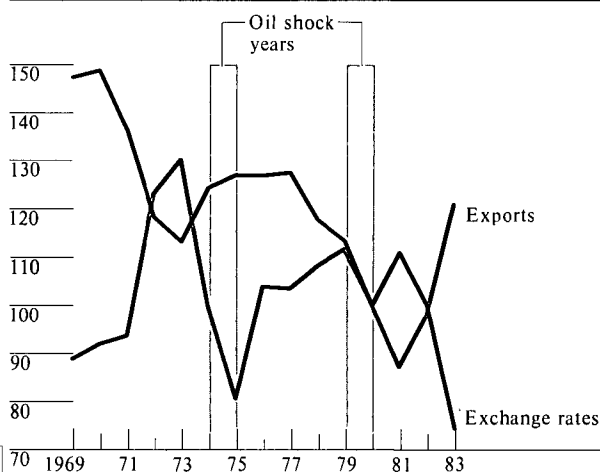
With these systemic problems untouched, an effort to expand domestic consumption and investment would worsen inflation and reverse recent gains in trade performance. Yugoslavia would simply add another phase to the cycle of stop/go adjustment that characterized economic performance throughout the 1970s. The key difference between Belgrade's current situation and that of the 1970s is that foreign lenders are now unlikely to extend the credits needed to finance import-led growth. Expansionary policies would soon produce large financing gaps, forcing a reduction in imports and a renewed contraction of domestic demand. []

Apart from the lack of basic adjustment, Belgrade's projections seem implausible because they rest on overly optimistic assumptions about export growth. The 7-percent target for growth in real exports implies an increase in Yugoslavia's market share in the OECD. Although the export gains in 1983-84 did boost Yugoslavia's share of the OECD market, further gains will be difficult:

- Because of the inflationary impact, Belgrade does not want to continue the large effective devaluations of the dinar that provided the main boost to exports in 1983-84.
- Yugoslavia has little scope left for diverting goods from soft currency CEMA markets to the West because there is little demand for many of its exports in Western markets. In addition, the CEMA countries, particularly the USSR, are not likely to tolerate growing Yugoslav deficits in bilateral trade.
- Yugoslavia also faces growing competition from developing countries in OECD markets as well as Western protectionism. The West Europeans already have accused Yugoslavia of dumping some products, and further increases in market shares would be likely to provoke tougher restrictions. []

Yugoslavia: Real Exchange Rates and Real Exports to the OECD, 1969-83

Index: 1980=100



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Outlook

On the basis of our econometric model of the Yugoslav economy, we believe that Yugoslavia's financial situation will remain much more tenuous through the remainder of the 1980s than the cash flow forecast given by Belgrade to its creditors. Using the long-run relationship between the growth of Yugoslav exports and OECD growth, we estimate that hard currency exports will grow by about 2.5 percent annually in real terms (about 6.8 percent in nominal terms) through 1990. Even holding real import growth for Yugoslavia equal to an average 2 percent (below the rate Belgrade claims it needs to meet its targets for growth of gross social product and exports), the hard currency trade deficit rises steadily to \$1.6 billion by 1990 instead of holding at roughly \$1.3 billion as projected in the Yugoslav forecast. Because of higher interest payments than the Yugoslavs assume, we

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**Yugoslavia: Hard Currency External
Debt and Payments, 1983-90 ^a**

Million US \$

	1983	1984 ^b	1985 ^c	1986 ^c	1987 ^c	1988 ^c	1989 ^c	1990 ^c
Financing gap	0	0	0	372	532	1,003	257	496
Financing requirement	4,038	3,600	3,336	3,787	4,115	4,608	2,354	1,520
Current account balance	299	730	650	506	210	38	-85	-164
Trade balance	-1,798	-1,340	-1,438	-1,465	-1,511	-1,546	-1,584	-1,622
Exports	6,271	6,898	7,418	7,923	8,440	9,002	9,597	10,230
Imports	8,069	8,238	8,856	9,388	9,951	10,548	11,181	11,852
Net services and transfers	2,097	2,070	2,088	1,971	1,721	1,584	1,499	1,458
Interest payments (net)	1,489	1,650	1,809	1,792	1,739	1,903	1,885	1,749
Repayment of medium- and long-term loans	2,560	3,200	3,544	3,924	3,979	4,268	2,116	1,199
Repayment of short-term loans (net)	670	100	0 ^d	0 ^d	0 ^d	0 ^d	0 ^d	0 ^d
Credits to foreign countries	157	100	200	150	154	160	165	170
Credits (other)	0	330	0	0	0	-110	-110	-110
Change in reserves	-55	600	242	219	192	328	98	97
Errors and omissions	-1,005	0	0	0	0	0	0	0
Borrowing sources	4,038	3,600	3,336	3,415	3,583	3,605	2,097	1,024
Medium- and long-term trade credit utilization	4,038	3,600	3,336	3,787	4,115	4,608	2,354	1,520
Total rescheduling	1,766	2,190	2,003	1,512	1,312	920	497	124
New credits	2,272	1,410	1,333	1,903	2,271	2,685	1,600	900
Total debt outstanding ^e	19,000	19,300	19,092	18,955	19,091	19,431	19,669	19,990

^a CIA projections.^b Estimated.^c Projected.^d Assumes short-term credit lines maintained.^e Assumes new lending or rescheduling covers financing gaps.

project that net services and transfers will fall to roughly \$1.5 billion instead of rising to \$2.4 billion. As a result, our estimates of Yugoslavia's current account surplus gradually fall after 1984, and a small deficit is possible by 1989.

If current account balances come close to the levels we project and Belgrade follows through with plans to rebuild reserves to cover three months' worth of imports, Yugoslavia is likely to fall short on its financing requirements even with generous reschedulings and substantial new credits. If Yugoslavia reschedules all original maturities with Western governments and banks between 1985 and 1988, it

would still face some \$10 billion in maturing principal. This debt includes loans from suppliers and socialist and Arab countries not covered by the reschedulings; obligations to multilateral lending institutions; repayments on new credits granted after 1982; and repayments of principal on debt rescheduled in 1983-84. At this time, the banks do not plan to refinance new credits or previously rescheduled debt. The Yugoslavs would also have to finance an estimated net outflow of \$660 million in credits to support their exports in 1985-88, and a reserve buildup of approximately \$1 billion. These

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requirements exceed the \$1.4 billion in current account surpluses we project for the period, as well as the \$8.2 billion in new private and official lending Western banks foresee. We project that financing gaps will reappear by 1986 and grow to \$1 billion by 1988 even if there is no net repayment of short-term debt. [REDACTED]

The options available for closing these financial gaps will prevent Belgrade from achieving its goals of less complicated dealings with creditors, a reduced debt burden, and an easing of austerity policies. The Yugoslavs could forgo a buildup of reserves or keep tight controls on imports, but minimal reserves would leave the country vulnerable to liquidity problems, and import cuts would constrain economic growth. The other course of action would be new lending or rescheduling the debt refinanced in 1983-84 and credits granted after 1983. Because commercial creditors seem unwilling to extend substantial new medium- and long-term credits, any new bank lending would probably be only to shore up existing loans. A new credit package or additional reschedulings almost certainly would entail difficult negotiations and continuation of IMF-supported austerity measures. Neither of these options would reduce Yugoslavia's debt service burden but merely push an even larger burden into the next decade. Despite Belgrade's optimistic hopes, Yugoslavia faces more years of difficult relations with foreign creditors and tight external constraints on economic growth. [REDACTED]

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East Germany: A Case of Successful Adjustment

Following several years of painful austerity and major foreign trade adjustments, East German economic growth rebounded in 1983-84 making East Germany the standout economic performer in Eastern Europe. Although East Berlin's debt remains large requiring continued austerity, we believe East Germany's efforts—with West German financial help—have reduced markedly the immediate threat of financial crisis, and improved the prospects for sustained growth while at least keeping the current account in balance. Now, East Berlin's major uncertainty is Moscow's tough trade demands that are likely to be a major determinant of East Germany's economic prospects in the late 1980s.

Financial Crisis Forces Adjustment

East Germany's financial problems, like those of most East European countries, go back to the early 1970s. The Eighth Communist Party (SED) Congress in May 1971, under new party leader Erich Honecker, established two main economic tasks—rapid growth and increasing levels of personal consumption—with little regard for the current account balance. The result was chronic hard currency trade deficits and growth of net hard currency debt from \$1.0 billion in 1970, according to our estimates, to \$11.6 at yearend 1980.

Although the regime maintained its rapid growth policies through 1981, it seemingly became more worried about its deteriorating external position. As a result largely of a cut in imports of 18 percent, East Germany managed to achieve a 1981 hard currency trade surplus of \$60 million—its first surplus since the 1960s and an estimated \$1.6 billion improvement over 1980.

The imposition of martial law in Poland in mid-December 1981 triggered Western government and

East Germany: Hard Currency Financial Statistics

Million US \$

	Exports	Imports	Trade Balance	Current Account Balance	Net Debt
1970	1,261	1,560	-299	-293	1,007
1971	1,368	1,636	-268	-197	1,205
1972	1,642	2,125	-483	-383	1,229
1973	2,230	3,004	-774	-689	1,876
1974	3,014	4,082	-1,068	-1,019	2,592
1975	3,062	4,187	-1,125	-1,067	3,548
1976	3,643	5,234	-1,591	-1,446	5,309
1977	3,578	5,088	-1,510	-1,336	6,159
1978	4,158	5,295	-1,137	-1,094	7,548
1979	5,098	6,908	-1,810	-1,858	9,776
1980	6,555	8,145	-1,590	-1,600	11,592
1981	6,714	6,654	60	-489	12,267
1982	7,172	5,663	1,509	1,239	10,718
1983	7,624	6,300	1,324	1,309	9,033

banker reaction that quickly forced the East German regime to act even more vigorously.

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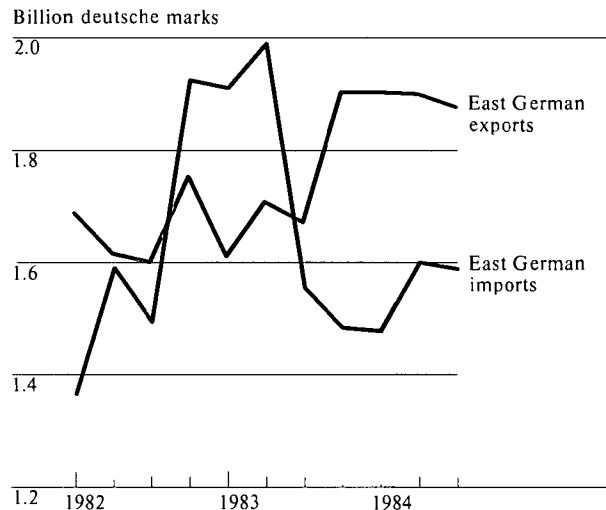
the regime sought quicker payment for its deliveries, negotiated delays in payment for its purchases, and accelerated its efforts to secure critical imports through barter and countertrade. We believe the regime also diverted to the West some goods originally scheduled for delivery to East European countries. As a result, East Germany boosted its hard currency trade surplus to \$1.5 billion in 1982.

The West German Umbrella

The East Germans also used their "special relationship" with West Germany to help avoid a liquidity crisis. After running surpluses on intra-German trade in 1980-81 and early 1982, they boosted imports and ran a deficit of around DM 900 million (US \$370 million) on intra-German clearing accounts in late 1982 and early 1983. At the same time, they slashed imports from other Western countries and paid off debt. The regime bought some commodities produced in third countries—such as feedgrains—through the intra-German account. It also sold some goods in third markets; West German officials estimate that these "switch deals" generated \$100 million in cash for East Berlin in 1983. Warming intra-German political relations also contributed to conclusion of new agreements—for example, on telecommunications services—that boosted East Berlin's already substantial hard currency receipts from Bonn.

East Germany also received financial help from West Germany. In June 1983 the Kohl government announced an unprecedented guarantee of an untied five-year DM 1 billion (then nearly \$400 million) loan from West German bank subsidiaries in Luxembourg that covered, we estimate, about one-eighth of East Berlin's 1983 financing requirement. In July 1984, the West German Government guaranteed a second loan on similar terms, this time for DM 950 million. The credit triggered unprecedented public criticism by the Soviets because of its linkage with a package of administrative changes—mainly involving easing of travel restrictions—that were seen as political concessions

East Germany: Trade With West Germany, 1982-84



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by East Berlin. The ensuing row forced the indefinite postponement of Honecker's long-planned, first-ever visit to West Germany. Ironically, we believe the East Germans needed the second credit much less than the first. In 1984 the East Germans returned to substantial trade surpluses with West Germany.

Improved Financial Situation

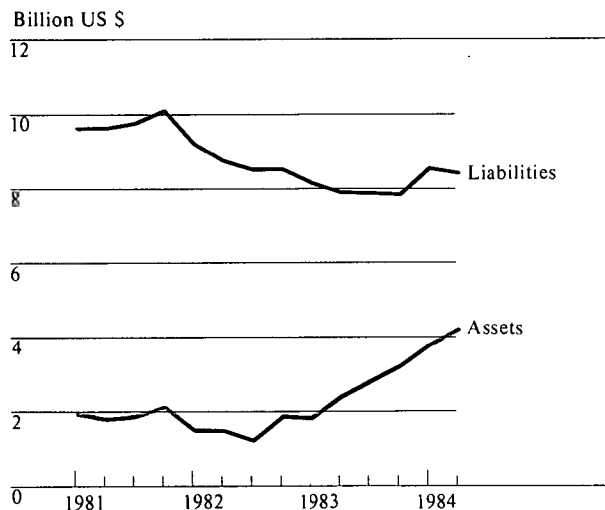
The threat of a liquidity crisis began to ease by mid-1983, even before the first West German guarantee. Some Western bankers, already impressed by East Berlin's improved trade performance, viewed Bonn's guarantee as proof of a West German financial "umbrella." Banker confidence was boosted further by Bank for International Settlements figures that showed reductions in debt

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East Germany: Position With Banks Reporting to the Bank for International Settlements (BIS), 1981-84



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to Western banks and steady increases in reserves. By early 1984, [] East Germany had a fairly easy time securing short-term trade financing, and in May East Berlin returned to the medium-term market, receiving a five-year \$75 million loan on relatively favorable terms. []

By late 1984, buoyed by the second West German loan and continuing improvement in East Berlin's financial condition, Western bankers had lent another approximately \$500 million in three more medium-term loans, including a \$400 million syndication in December that was the largest commercial credit received by any East European country since 1980. The loan originally was for \$150 million but was increased after heavy oversubscription. The syndication had no West German Government backing and was on terms more favorable than the credits guaranteed earlier by Bonn. []

By yearend 1984, aided by another hard currency trade surplus, which we estimate to be in the range of \$0.5 billion to \$1 billion, net debt probably had fallen to about \$8 billion—less than two-thirds of the end-1981 level. We believe that East Germany's assets at yearend with BIS reporting banks probably were somewhat higher than the \$4.2 billion reported at midyear, when East Germany's deposits were greater than all other East European countries' assets combined. As a result, East Berlin's reserves probably were sufficient to cover eight months' of import requirements. []

Slowdown in Growth

As import cuts disrupted industrial production in the first half of 1982, growth began to decline sharply. National income growth slowed to 2.5 percent in 1982, down from 4.8 percent in 1981. We calculate that real GNP growth fell from 2 percent to 0 in the same period and that real personal consumption actually declined in 1982 for the first time under Honecker. Moreover, austerity measures hit consumers especially hard; [] increased shortages, longer lines, and higher prices for many consumer goods. []

[] import reductions that cut growth also increased underemployment and caused some genuine unemployment. We estimate that the number of jobless reached at least 1 percent of the work force by late 1982, unprecedented for a traditionally labor-short country whose population has dropped continuously since 1949 and whose Constitution guarantees a job for all. []

Domestic Adjustment Measures

In addition to dramatic shifts in the external accounts, East Berlin since 1982 has made a number of adjustments in domestic economic policy to reduce domestic demand and boost net exports. Most important, the regime seems to have subordinated, at least temporarily, its priority of providing []

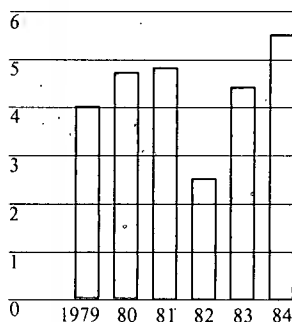
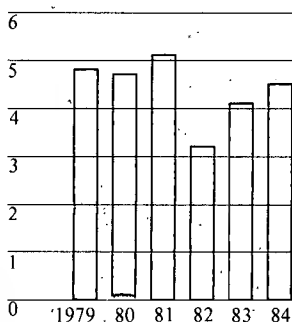
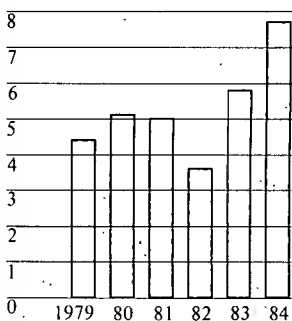
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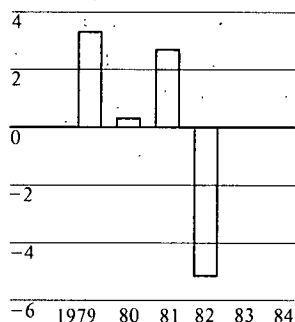
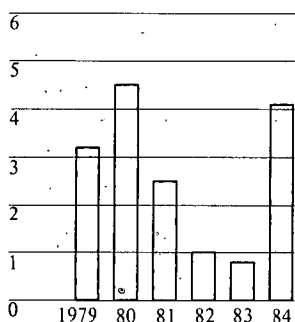
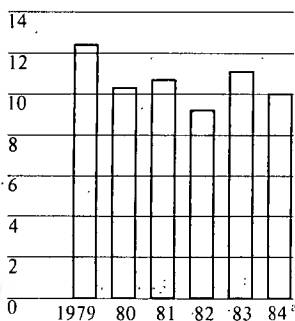
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East Germany: Selected Economic Indicators, 1979-84

Percent

Produced National Income**Industrial Production****Productivity in Industry**^a Through June.

Note scale change

Investment in the National Economy (Gross)**Retail Sales****Foreign Trade Turnover**

increasing levels of personal consumption to maintaining a balanced current account. [redacted]

Retail Price Increases. The regime raised prices on many consumer goods; increases were most common on imported luxury items in 1982 but [redacted] spread to many domestically produced products in 1983-84. We estimate that consumer prices rose 3 to 5 percent. [redacted]

Investment Policy. Import cutbacks contributed to declines in investment. Official statistics show that investment declined by over 5 percent in 1982 and was flat in 1983. Industry's share of the investment pie continued to rise as the regime redirected investment resources into import-substitution projects and resource conservation. The government also emphasized the modernization of existing plants over the construction of new ones, and concentrated more on completing ongoing projects. Politically sensitive housing construction, however, has not been significantly affected. [redacted]

Energy Conservation. To reduce the need for purchases of Western oil in the face of a cap on Soviet oil deliveries on soft currency account, East Berlin imposed severe conservation measures and accelerated the expensive development of its large reserves of lignite. As a result, lignite provided 71 percent of primary energy in 1983 versus 54 percent in 1980. To further reduce the demand for oil and improve efficiency, the regime drastically changed its transportation mix. The SED cut diesel fuel allocations to truck enterprises and imposed restrictions on the use of trucks. The regime mandated greater use of the more efficient railroads and domestic waterways, and increased the electrification of rail lines. [redacted]

Industrial Policy. Although generally avoiding the term "reform," East Berlin took the following steps to modernize and improve the efficiency of industry:

- The regime continued to give priority to micro-electronics, while boosting production of consumer goods, a large share of which it apparently intends to deliver to the USSR and to sell in the West.

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- To encourage more efficient use of industrial labor, it enacted, in April 1983, a 70-percent wage tax on enterprises that went into effect in 1984. It also summarily has moved some workers to enterprises needing labor. This has contributed, in our view, to the reported rise in industrial labor productivity of 7.7 percent in 1984.

- East Berlin altered the criteria used to evaluate enterprise performance and award bonuses. A November 1983 decree gave profitability increased importance as an enterprise performance criterion and raised the priority of exports, as well as energy and materials conservation; production costs reportedly have dropped.

Agriculture. To boost lagging production and reduce grain imports—which contributed significantly to the growth of debt in the 1970s—the regime announced in early 1983 a sweeping agricultural price reform that came into effect on 1 January 1984. The government boosted procurement prices—50 to 100 percent in most cases—while also sharply reducing subsidies for factor inputs. The regime hoped that larger monetary incentives would stimulate a lethargic agricultural managerial corps and a work force that in the past has shown little inclination to respond to exhortations for harder work. The regime credits these measures in part for the successful agricultural performance last year, when most production indicators rose appreciably and the grain harvest was a record 11.5 metric million tons.

Recovery in 1983-84

We believe East Berlin's adjustment efforts, with a boost from West German assistance, contributed markedly to the rebound in growth in 1983-84. The regime reported that the growth of national income accelerated in the second half of 1983 and reached 4.4 percent, slightly above the plan goal and near

precrisis levels (real GNP rose about 2 percent). East Germany thus was second only to the recovering Polish economy in growth of national income among East European countries in 1983 in contrast to its position as an average performer in the late 1970s. Official data indicate that in 1984 national income growth hit 5.5 percent, above the rates of the late 1970s, while industrial production was up 4.5 percent. Retail sales growth rebounded to 4.1 percent, and the country ran another—as yet unspecified—hard currency trade surplus. In addition, East Germany seems likely to have returned to surplus with the USSR for the first time in a decade.

Prospects

We expect East Germany to continue to run at least modest hard currency surpluses to reduce gradually its still-large debt and maintain bankers' confidence in its creditworthiness. The regime is likely to continue to push exports hard but, unlike some East European governments, is also likely to increase imports of capital goods and industrial inputs from the West as the growth of exports and Western banker lending policies permit. Although the domestic economy continues to face significant problems—including demographic troubles and an inefficient industrial plant in considerable need of modernization—we expect moderate real growth again in 1985.

We expect the consumer's lot to remain about the same. Although retail sales rose appreciably last year, official statistics indicate that growth slowed late in the year. Meanwhile, steadily rising prices, continuing shortages of luxury items, and popular pessimism that the supply situation will improve. Continued good trade performance could permit some increases in imports of consumer goods, but we expect living standards to rise only modestly over the next couple of years.

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The regime's comparative success in weathering its financial crisis and improving its creditworthiness is likely to make it even less willing to undertake decentralizing reforms. Instead, we expect East Germany to continue to work to improve administratively what already is probably the best run economy in Eastern Europe. Party officials seem likely to continue to argue that there are different national paths to socialism—sometimes an implicit dig at the Hungarians—and that, despite some admitted weaknesses, East Germany is happy with its way. [REDACTED]

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With the threat of financial crisis receding rapidly, East Berlin's major external economic uncertainties lie in Moscow. We believe negotiations for the 1986-90 bilateral trade protocol have been difficult,

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[REDACTED] The outcome of these talks is likely to be a major determinant of East Germany's economic prospects in the late 1980s.

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Romania: On a Financial Tightrope

Ceausescu's strategy for continued reduction in Romania's foreign debt without help from the IMF or foreign creditors will be undermined by poor export prospects and worsening domestic strains from the required austerity.

Some Western banks, to avoid another rescheduling, would probably be willing to extend some medium-term credits. If Romania does not borrow, Ceausescu has two unpalatable options. Hard currency imports could be cut further, damaging Romania's already wounded economy and undercutting export potential in coming years. Alternatively, Romania could request another rescheduling, an embarrassing option for Ceausescu, particularly since creditors would demand IMF participation. Whatever course, it will be increasingly difficult to put off dealing with the causes of lagging growth and poor export performance.

Ceausescu's Financial Strategy

Following rescheduling agreements with bank and government creditors in 1982 and 1983 and a standby arrangement with the IMF, Ceausescu embarked upon a "go-it-alone" course. Bucharest balked at IMF-supported measures that would lessen central control over the economy, and the standby accord for \$1.1 billion was canceled by mutual agreement in late 1983. At the same time, Ceausescu told his bank officials to avoid any new borrowing.

Ceausescu has maintained his hostile stance toward the IMF. The Romanian Government recently criticized the Fund and reversed a number of measures taken earlier in response to IMF recommendations. The currency unit, the leu, has been

Romania: Hard Currency Foreign Debt ^a

Billion US \$

1981	10.1
1982	9.7
1983	8.8
1984	7.9
1985	6.6
1986	5.5
1987	4.4
1988	3.3
1989	2.9

^a Includes short-term debt.

revalued, domestic interest rates have been lowered, and some domestic prices decreased. Ceausescu may be calculating that, if forced to ask for IMF assistance again, he would be able to reverse these decisions.

Ceausescu's unwillingness to borrow from banks or the IMF probably stems from his success in reversing the hard currency trade deficit. The reported 1983 hard currency trade surplus of \$1.7 billion was a dramatic shift from the \$1.5 billion deficit in 1980. The turnaround was achieved, however, largely by forced hard currency import cuts of 40 percent over 1981-82; when Romania was in deep arrears and suppliers stopped shipments, and by a further 3 percent in 1983.

Domestic Economy Suffers

The impact of these cuts has been severe. We estimate that GNP growth slowed from an average

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**Romania: Hard Currency Financing
Requirements and Sources**

Million US \$

	1982	1983	1984	1985	1986	1987	1988	1989
Financing requirements	4,160	2,094	260	116	140	192	167	-367
Current account balance	655	922	1,030	1,200	1,310	1,380	1,470	1,520
Trade account balance	1,525	1,688	1,750	1,850	1,890	1,890	1,890	1,910
Exports	6,235	6,246	6,480	6,780	7,240	7,720	8,260	8,830
Imports	4,710	4,558	4,730	4,930	5,350	5,830	6,370	6,920
Net interest	-917	-737	-750	-700	-600	-520	-380	-325
Other services	47	-29	30	50	20	10	-40	-65
Debt repayments	3,170	2,152	1,220	1,405	1,250	1,372	1,337	753
Medium and long term	2,081	1,211	1,120	1,385	1,250	1,372	1,337	753
Short term (net)	1,089	941	100	20	0	0	0	0
Net credits extended	502	476	70	-89	200	200	300	400
Arrears from previous year	1,143	388	0	0	0	0	0	0
Financing sources	3,316	1,876	259	116	140	192	167	-367
Credits	1,591	1,056	359	57	232	212	290	337
Medium and long term	334	586	315	240	400	400	400	400
Short term	956	338	0	0	70	50	50	50
IMF (net)	301	132	44	-183	-238	-238	-160	-113
Debt relief	1,700	749	0	0	0	0	0	0
Change in reserves	-25	-71	100	-59	92	20	123	704
Errors and omissions	844	218	1	0	0	0	0	0
Financing gap/arrears	388	0	0	0	0	0	0	0

annual rate of 4 percent in 1976-80 to 1 percent in 1981-83. Although investment growth has fallen, the burden of adjustment has been primarily on consumers. Quality foods, especially livestock products, are in extremely short supply, and most staple foods are rationed. Moreover, the austerity program is undercutting Romania's potential for export growth. Not only are prospects for future economic growth being undermined by cuts in the import of investment goods, but inputs critical to generating export goods in the near term are being sacrificed. A noteworthy case is the agricultural sector, which is suffering from a lack of seed, pesticides, fertilizers, and agricultural machinery—items that are either being exported for hard currency or the import of which is being restricted to avoid hard currency outlays.

The Financial Picture in 1984

Romania's external financial constraints eased in 1984. Scheduled repayments of debt were about half the 1983 level. Sources of financing, however, also dropped dramatically from 1983 levels, leaving the Romanians dependent on a large trade surplus to cover their hard currency needs.

Preliminary trade statistics indicate that Romania achieved a substantial hard currency trade surplus last year, but perhaps not as large as needed. Romanian bank officials appear concerned about liquidity problems.

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[redacted]

These cash flow problems also help explain why Romania has continued to squeeze some foreign suppliers by demanding that they accept delayed payments, settle for discounted payments, or take Romanian goods in lieu of cash.

[redacted]

[redacted]

Mixed Signals About Borrowing

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Ceausescu's no-borrowing dictum has kept Romanian banking officials on a short string, limiting their ability to line up potential credits that would provide a cushion if liquidity problems arise this year. Since last fall some Western bankers have been urging the Romanians to line up credits from official and multilateral sources as well as from commercial banks to cover what they believe will be a \$400 million financing gap in 1985.

[redacted]

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The Romanians have been giving mixed signals about their borrowing intentions for several months:

[redacted]

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Financial Plan, 1985-89

The basic operating principle of Ceausescu's financial plans for 1985-89 is to pay off external financial obligations with no new borrowing. With no new projected borrowing except for small development credits, the burden of debt repayment in coming years will rest on the trade surplus. Because of the tight financial situation, plans do not call for rebuilding foreign currency reserves until 1989.

[redacted]

Scheduled medium- and long-term principal and interest obligations will amount to about \$2 billion annually in 1985-88. These amounts include debts rescheduled in 1982-83.¹ In addition, Romania is scheduled to begin to repay debt due the IMF in 1985. Because Ceausescu has forbidden further borrowing, Romania's net credits from the World Bank, commercial banks, and governments are projected to be less than \$200 million annually on average, leaving \$1.7-1.9 billion to be covered by hard currency trade surpluses.

[redacted]

¹ Debt rescheduled in the 1982 agreements comes due in 1985-88. Debt rescheduled in the 1983 commercial bank agreement comes due in 1987-89, and that rescheduled in the 1983 Paris Club agreement must be paid in 1986-89.

[redacted]

We believe that at least some Romanian approaches may have been made without Ceausescu's knowledge, and we expect officials to maneuver around his ban on new borrowing.

[redacted]

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[redacted]

[redacted] Ceausescu's late November attack on the IMF and "other world bodies and banks" likely reinforced their fear of incurring his wrath. Meanwhile, they doubtlessly are aware that another liquidity crisis in 1985 would incur at least as much displeasure from Ceausescu. [redacted]

[redacted]

Limited Options

We believe that it will eventually become clear to Ceausescu that trade surpluses cannot alone fill Romania's financial gap. Three years of severe austerity and sharp import cutbacks have taken their toll. Because this type of adjustment has failed to deal either with the damage done to growth and export potential or the economic misery created for workers and consumers, it cannot get Romania through the next four years. Therefore, if, as we expect, Ceausescu fails to achieve his targets for large trade surpluses, he will be forced to consider a resumption of borrowing, further import cuts, or rescheduling.

New Borrowing. The Romanians might still negotiate an arrangement with Western banks for medium-term loans, but they will not be able to indulge their political preferences on where to borrow. Because Romania has covered its debt obligations in 1984 and demonstrated its willingness to take tough measures to meet its obligations, a few Western banks with Romanian debt exposure might be willing to quietly help avert a liquidity crisis that would cause payment delays. On the other hand, Ceausescu might be persuaded by his banking officials to accede to a rollover loan if it is not characterized as "new" or "additional credit." Indeed, the bankers may be hoping

that he would accept a loan package if they could show it is necessary to avoid rescheduling. [redacted]

More Import Cuts. If the Romanians are not able to obtain financing under these difficult conditions, Ceausescu probably would impose further import cuts to generate more hard currency. He reportedly has said he will order cuts of up to 30 percent in 1985 imports if necessary. Such action—coming on the heels of largely arbitrary and poorly planned hard currency import cuts in 1981-83—would seriously damage an already limping economy, and it would undercut Romania's ability to produce export goods in future years. Bucharest would almost certainly be unable to sustain such cuts, economically or politically, over the next four years. [redacted]

Rescheduling. Ceausescu's other option—a request for rescheduling—is probably the least palatable. Not only would this be embarrassing, but foreign government creditors, and perhaps commercial bank creditors as well, would demand IMF participation. The IMF would probably make any assistance conditional on requirements more far reaching than those imposed in 1981-83. Ceausescu, who is highly sensitive to any weakening of his control over the rigidly centrally planned economy, probably would resist IMF conditions, making rescheduling negotiations contentious and protracted. [redacted]

If Romania is to avoid arrears, further borrowing—in some form—seems inevitable. Additional credits would give Ceausescu some scope to increase production and exports but would have to be integrated with a new economic strategy focused on rebuilding economic growth and exports. Last-minute "panic" borrowing to avoid arrears, however, would do little to mitigate Romania's still-severe economic adjustment problems. [redacted]

[redacted]

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